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Supreme Court of the United States

OCTOBER TERM, 1934.

No. 51.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

UNION PACIFIC RAILROAD COMPANY

On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

BRIEF FOR RESPONDENT

The Evening Post Job Printing Office, Inc., 134 Fulton St., New York, N. Y.

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BRIEF FOR RESPONDENT.

The opinion of the Board of Tax Appeals (Transcript, p. 41) is reported in 26 B. T. A. 1126. The opinion of the Circuit Court of Appeals (Transcript, p. 97) is reported in 69 Fed. (2d) 67. The part of the opinion of the Board of Tax Appeals dealing with the question here sought to be reviewed commences at page 52 and that of the Circuit Court of Appeals at page 101 of the transcript.

Statement of the Case.

The question presented is the right to a deduction in each of the tax years, 1920, 1921, 1922 and 1923, of the annual amortization of commissions to bankers and underwriters incurred on three bond issues sold prior to 1913.

The facts regarding the several bond issues are briefly but sufficiently stated in the Commissioner's brief at page 3 and more fully in a footnote on pages 13 and 14. Such statements are satisfactory to the respondent, subject, however, to the comment that no inference can properly be drawn that the payment of the commissions in any of the three cases was a cash disbursement to the bankers and underwriters by the corporation issuing the bonds rather than a deduction of the amount of the commissions by the bankers and underwriters in paying over to the corporation the proceeds of the sale of the bonds. It being our opinion that the question of law as to the propriety of the amortization deduction ought not to turn upon the manner in which the payment was handled, the facts were so pleaded in the petition to the Board of Tax Appeals as to avoid a definite showing as to the method by which the liability for commissions was satisfied. See amended petition for 1920-22, pages 19 to 25 of the transcript, and for the year 1923 at pages 33 to 39 of the transcript.

Commissioner's Contention.

In contending that commissions incurred on bond issues made prior to 1913 are not entitled to amortization deduction in current tax years, the argument submitted in the Commissioner's brief is:

(1) That since annual amortization of *premiums* realized on bond issues prior to 1913 may not be subjected to taxation as income of the current tax years, as held by this Court in *Old Colony R. R. Co.* v. *Commissioner,* 284 U. S. 552, it is "anomalous and unreasonable" to allow the deduction of amortization of prior-to-1913 *discount,* as the current Treasury Regulations do; and

(2) That, since commissions are analogous to discount and premiums, uniformity of treatment requires that discount and commissions, as well as premiums, on prior-to-1913 bond issues, all be denied recognition.

The first proposition above concededly involves the repudiation of the recognition in the official regulations of the deduction of discount amortization so far as discount prior to 1913 is concerned, although such recognition was compelled by court and Board of Tax Appeals decisions from which the Commissioner did not appeal.

The second proposition above involves a reversal of the position taken in behalf of the Commissioner below. It was contended below that commissions were *not* analogous to discount and hence were not entitled to amortization under the decisions which Commissioner was then accepting as establishing the right to deduction of amortization of discount incurred prior to 1913.

Development of the Question.

This question as to commissions is a tag-end of a long controversy, and a narrative of that whole controversy is necessary to the Court's understanding in proper perspective of the question presented.

Amortization of discount, commissions and expenses on bond issues always recognized if incurred after March 1, 1913.

From the beginning of its administration of the income tax laws the Bureau of Internal Revenue in its official regulations recognized the right to deduct annual amortization of discount incurred on the issue of corporate bonds and in fact required amortization (Article 135 of *Regulations 33,* governing the administration of the 1913 law). The same regulations as revised to govern the administration of the 1916 law expressly included in such annual amortization the commissions and incidental expenses incurred in connection with bond issues (Article 150 of *Regulations 33 revised*). Subsequent regulations governing the later income tax laws

While the subsequent regulations have not contained express mention of commissions and incidental expenses, it has at all times continued to be the practice of the Bureau to amortize commissions and incidental expenses as well as discount (See Commissioner's brief, p. 4 and administrative rulings cited on p. 9 thereof).

Bureau made exception, however, and disallowed amortization if bonds were sold prior to 1909.

The general rule previously stated was however subject to an exception to the effect that such amortization would not be allowed in case the bonds had been sold prior to 1909 and the discount charged to income or profit and loss in the year of issue (*Treasury Decision* 2161, dated February 19, 1915, and Article 149 of *Regulations 33 revised*). This exception was based on the theory that the charging off of the entire discount in some year prior to the incidence of the Corporation Excise Tax Act of 1909, being the first income tax law, constituted a conclusive election to treat the discount as a closed transaction.

Board and Court overruled exception and recognized amortization of bond discount incurred prior to 1909.

The above stated position of the Bureau was at first sustained by the Board of Tax Appeals in *Western Maryland Railway Co.*, 12 B. T. A. 889, 907. That decision was, however, shortly thereafter overruled by the Board in *Chicago, Rock Island & Pacific Railway Co.*, 15 B. T. A. 988, 1027-1034, which held that the amortization of discount must be recognized equally whether the bonds were sold prior to the incidence of the income tax laws or thereafter and regardless of the taxpayer's method of accounting for the discount. *The Commissioner did not appeal.* The decision to the contrary in the *Western Maryland* case was reversed by the Circuit Court of

Appeals for the fourth circuit in 33 Fed. (2) 695, 696, and *the Commissioner did not seek certiorari.*

The Board has consistently followed its decision in the *Rock Island* case as to discount amortization (*Kansas City Southern Ry. Co.,* 16 B. T. A. 665, 686; *St. Louis Terminal Railroad Association,* 17 B. T. A. 1135, 1169; *Chicago & North Western Railway Co.,* 22 B. T. A. 1407, 1435). *No appeals have been taken by the Commissioner from any of those decisions as to the discount question.*

Board and Court, however, in Rock Island case distinguished expenses from discount and disallowed amortization of prior-to-1913 incidental expenses of bond issues.

The *Rock Island* case, *supra,* involving the question of prior-to-1913 discount, also involved among numerous other questions the question of amortization of incidental expenses of bond issues prior to 1913. The Commissioner, consistently with his then position as to the bond discount, denied the right to such amortization. The Board, although it had just held in the same opinion that prior-to-1913 discount was entitled to amortization, concluded that the incidental expenses of a bond issue differed from discount and sustained the contention of the Commissioner against the allowance of amortization of such incidental expenses. This decision was in deference to the decision of the Circuit Court of Appeals of the first circuit in *Commissioner* v. *Old Colony R. R. Co.,* 26 Fed. (2d) 408, against the taxation of annual amortization of premiums realized on prior-to-1913 bond issues.

This decision as to prior-to-1913 expenses was affirmed by the Circuit Court of Appeals for the seventh circuit in *Chicago, Rock Island & Pacific Ry. Co.* v. *Commissioner,* 47 Fed. (2d) 990, 991. The Rock Island petitioned for a writ of certiorari which was denied by this Court, 284 U. S. 618.

Thereupon the Bureau naturally sought to differentiate commissions from discount and disallow amortization of prior-to-1913 commissions as analogous to incidental expenses.

When the Bureau was defeated, as above shown, as to prior-to-1909 discount but was sustained as to prior-to-1913 incidental expenses there were pending some other railroad cases involving the question of amortization of prior-to-1909 bond discount. In an endeavor to salvage as much as possible out of the defeat on the discount question, the Bureau asserted in these cases a distinction between strict discount and commissions to bankers and underwriters and took the position that such commissions were ruled by that part of the decision in the *Rock Island* case, *supra,* against the amortization of prior-to-1913 expenses rather than by that part of the same decision in favor of the amortization of prior-to-1909 bond discount. The first case to come before the Board on this issue was that of the *Kansas City Southern Railway Co.,* 22 B. T. A. 949, 966. The Board decided without discussion that the amortization of prior-to-1913 commissions was not allowable, citing its decision as to the amortization of prior-to-1913 expenses in the *Rock Island* case.

When the Union Pacific Railroad Company's cases, out of which the present granted certiorari grows, came before the Board the Commissioner contested the allowance of commissions incurred prior to 1913, although conceding that the right to deduct amortization of discount, whenever incurred, was established (Board opinion, Tr., pp. 52-53). The Board disallowed the amortization of such commissions on the authority of its decisions against amortization of prior-to-1913 expenses in the *Rock Island* case, *supra,* and against the amortization of prior-to-1913 commissions in the *Kansas City Southern* case, *supra.* The Circuit Court of Appeals for the second circuit in the present case has reversed the Board on this point (Tr., pp. 101-103). The court below expressed the opinion that commissions should be dealt with on the same basis as discount. But its opinion did not rely wholly upon this reasoning. In other words, it was of the opinion that the recognition of the commission amortization could be sustained on broader grounds, which would appear to indicate that court's dissent from the result reached by the Circuit Court of Appeals of the seventh circuit in the *Rock Island* case as to the amortization of incidental expenses, although the opinion below does not expressly state such dissent.

It seems desirable to call attention to some inadvertent errors made in the Commissioner's brief in the statement of the Bureau's practice in the past, although the foregoing historical narrative necessarily corrects any statements in the Commissioner's brief which are in conflict

with statements in such narrative. On page 5 of the Commissioner's brief it is stated that: "As to premium "and discount on bonds issued before 1913 the Treasury "Regulations formerly authorized the amortization of both "premiums and discount." The quoted statement is incorrect as to prior-to-1913 *discount*. Article 149 of Regulations 33, revised, expressly excluded amortization of prior-to-1913 discount. And while the express exclusion was not continued in all later editions of the regulations, the practice continued the same until the decisions in the *Rock Island* and *Western Maryland* cases, *supra*, compelled the abandonment of that practice. In the footnote on pages 7 and 8 of the Commissioner's brief it is stated that: "the Commissioner in fact continued to permit tax-"payers to amortise and deduct commissions on bonds "issued prior to 1913 * * * until the decision of the "Board of Tax Appeals in *Chicago, R. I. & P. Ry. Co.* "case, 13 B. T. A. 988, 1034". This is wholly inaccurate. The Commissioner was denying the deduction of amortization of prior-to-1913 commissions as a part of discount until the decision in the *Rock Island* case sustained the right to deduction of amortization of the discount, and even thereafter the Commissioner has at all times sought to distinguish commissions from discount and has denied their deduction in the case of bonds issued prior to 1913. On Page 10 of the Commissioner's brief it is stated that: "Formerly the Treasury Regulations made no distinction "as to premiums and discount between bonds issued prior "to 1913 and those issued after that date". The regulations and the practice made a very substantial distinction in that the amortization of premiums was required until

this was held invalid by this court in the *Old Colony* case, 284 U. S. 552, while at all times the deduction of amortization of prior-to-1909 discount was denied until its recognition was required by the decision in the *Rock Island* case, *supra.*

ARGUMENT.

POINT I.

The Commissioner now asserts that bond commissions are wholly analogous to bond discount. This forecloses further argument, for the Board sustained in these same cases, with the acquiescence of the Commissioner, the deduction of amortization of the discount on the same bond issues and the Commissioner did not appeal.

We have shown in our narrative of the development of this controversy that the Commissioner has by a long course of conduct accepted decisions of the Board and Circuit Court of Appeals for the fourth circuit as establishing the right to amortization of prior-to-1913 discount. This was true notwithstanding the fact that at the time of the Board's first decision to this effect in the *Rock Island* case, 13 B. T. A. 988, 1027-1034, the Circuit Court of Appeals for the first circuit had held in the *Old Colony* litigation, 26 Fed. (2d) 408, that prior-to-1913 premiums were not taxable as current income in the form of amortization. The Board in its said decision discussed the *Old Colony* decision and concluded that it had

no bearing on the discount question (13 B. T. A. at 1029). The Commissioner failed to take an appeal from the decision of the Board in the *Rock Island* case. He omitted to apply for certiorari to review the same decision of the Circuit Court of Appeals for the fourth circuit in the *Western Maryland case,* 33 Fed. (2d) 695, 696. He omitted any appeal on this point from a number of subsequent decisions by the Board. His brief in this case at page 12 states that he did not raise the discount question in *New York, Chicago & St. Louis R. R. Co.* v. *Burnet,* 64 Fed. (2d) 152, 154, in the Court of Appeals for the District of Columbia. It is evident, however, that a hope has been entertained in the Bureau of Internal Revenue that by some reasoning this court's decision in the *Old Colony* case, 284 U. S. 552, might be used as a means of upsetting the very formidable body of decisions sustaining the right of deduction of prior-to-1913 discount amortization, for the government sought to raise the question in *Tait* v. *Western Maryland,* 62 Fed. (2d) 933, in the fourth circuit but was precluded by a plea of *res adjudicata.* The Commissioner's brief in the present case states at page 12 that the government abandoned the question of bond discount in *Tait* v. *Western Maryland* when that case was presented to this court, 289 U. S. 620.

The present cases involved claims for the deduction of discount amortization as well as claims for the amortization of commissions on the same three bond issues made prior to 1909. The Board allowed the claims for amortization of discount amounting to $251,000 in each of the

tax years, while disallowing the claims for deduction of commission amortization amounting to $57,000, and stated in the opinion that counsel for the Commissioner conceded that the prior decision of the Board in the *Rock Island* case decided the discount question adversely to him (Tr. pp. 52 and 53). The Commissioner took no appeal from the Board's decision allowing the discount amortization. Therefore the right of the respondent to the deduction of the discount amortization claimed in these cases is conclusively established.

We understand the Commissioner's case before this Court to be based on his assertion that commissions are wholly analogous to discount and premiums. The analogy of discount, premiums and commissions is twice stated on page 5. On page 10 is stated the belief that "premiums, "as well as discount and commissions, are all similar and "should all be treated alike". On pages 13 and 14 it is said: "The Commissioner's action (as to the treatment "in this case of some of the commissions as a part of the "discount) amounts to a tacit admission that the distinc- "tion between commissions and discounts is tenuous and "elusive". Again on page 15 it is said: "However, prem- "iums, discounts, commissions, and incidental expenses "all stand on the same footing". In other words, the Commissioner stakes his whole case on the hope of persuading this Court that the reasoning of its decision in the *Old Colony* case, 284 U. S. 552, as to prior-to-1913 premiums is equally applicable to prior-to-1913 discount and commissions. That contention may be available to the Commissioner in some other case but it does

not seem that in this case, in which the right to deduction of discount has become *res adjudicata,* it is open to the Commissioner to assert that prior-to-1913 discount is not entitled to tax deduction and that the deduction of prior-to-1913 commissions must also be excluded because of their complete analogy to bond discount.

POINT II.

But, if the Commissioner's argument is not foreclosed, we agree that the analogy between commissions and discount is complete, but submit that the reasoning of the decision in the Old Colony case, 284 U. S. 552, has no application to the question of amortization of discount and commissions.

When this case was before the Board and before the Circuit Court of Appeals it was the position of the Commissioner that commissions should be distinguished from strict discount and classified with incidental expenses so that he might invoke the application of the decision of the Circuit Court of Appeals for the seventh circuit in the *Rock Island* case, 47 Fed. (2d) 990, 991, denying amortization to prior-to-1913 incidental expenses. In fact this view continued to be entertained until and including the preparation of the petition for certiorari in this case, for that petition is based upon an alleged conflict of decisions. The decision below in this case was asserted to be in conflict with the decision in the seventh circuit as to incidental expenses.

The court below, as one but not the sole ground of its decision, sustained our contention that there is a complete analogy between strict discount and commissions. In view of the Commissioner's present agreement to that proposition, it is evidently not necessary to argue it, but we, nevertheless, submit the following demonstration of the proposition.

There is no justification for drawing a distinction between the commissions involved in this case and the strict discount. From the standpoint of the issuing corporation the discount and the commissions are indistinguishable. If the corporation retains bankers to sell for its account an issue of bonds at 96 with an undertaking to pay the bankers a two per cent. commission, the corporation realizes only a net amount of 94 as the new capital it sought and the cost of that new capital is the sum of the discount and the commission, namely, six per cent. of the face value of the issue. The result is precisely the same if the bankers purchase the bonds outright at 94 and resell them for their own account to the public at 96. If bonds are offered to the public at 96 with a syndicate underwriting at a two per cent. commission, the net amount of 94 is the new capital realized by the corporation and the cost of that new capital is six per cent. of the face value of the issue; and this is equally true whether the bonds are purchased by the public or by the underwriting syndicate. In the several foregoing examples six per cent. of the face value, representing the cost of securing the use of the new capital, will stand throughout the life of the bonds as a liability which must be met at the maturity of the bonds and which should therefore be amortized over the

life of the bonds and taken as deductions annually and ratably. There is no possible justification for a different treatment for tax purposes of any of the above suggested transactions.

The distinction which the Board, at the instance of the Commissioner, has made in the case of bond commissions depends wholly upon giving controlling importance to the identity of the persons who received the benefit of the commissions or the discount as the case may be. If that benefit went to the purchasers of the bonds, it is treated as discount and its amortization is allowed, even though the transaction occurred before 1913. If the benefit went to other persons than the purchasers of the bonds, it is treated as a commission and in that case the amortization is not allowed because the transaction occurred prior to 1913. Indeed, in the present case in the two instances in which the underwriters were themselves required to take up the bonds, the taxpayer has been allowed the amortization of both the discount and the underwriters' commission, although the transaction was prior to 1913; but in those instances in which the underwriters earned their commission without taking up the bonds, the amortization of their commission has not been allowed because the transactions occurred prior to 1913. The *bankers'* commissions upon all three issues of bonds involved in the present case have been disallowed amortization, because the issues were prior to 1913, although if the bankers had bought the bonds outright, at prices representing the net amount realized by the issuing corporations after the deduction of commissions, amortization would have been allowed. It is obvious that the identity of the persons receiving the benefit of any allowance from the face

value of the bonds or from the proceeds is not a consideration which should control the question of the right of the corporation to deduct amortization. It is the issuing corporation's tax liability which is concerned, and the question of the deduction of amortization should be determined by the effect on the issuing corporation of the benefits it has allowed in connection with the issue of its bonds. The effect upon the issuing corporation is the same whether the cost which it has incurred is called "discount" or "commission"; it is the same whether, if called "commission", it went to an underwriter who was obliged to take up the bonds and so obtained the benefit also of the discount, or to an underwriter who was not obliged to take up the bonds and therefore had the benefit only of the commission.

The foregoing discussion demonstrates, we submit, that bond discount and commissions to underwriters and bankers in connection with the issuing of bonds, are indistinguishable from the standpoint of the issuing corporation and must be accorded the same treatment for tax purposes. Since, in the present case and under the decisions hereinbefore cited, the amortization of discount is allowed as a current deduction, even though the bonds were sold prior to 1913, it must follow that amortization of the commissions incurred on the same bonds prior to 1913 is entitled to allowance as a deduction in the current years.

In the *Rock Island* litigation the decisions of both the Board and the Circuit Court of Appeals for the seventh circuit rested the denial of amortization of prior-to-1913 incidental expenses upon an assumed analogy to the holding in *Commissioner* v. *Old Colony R. R. Co.*,

26 Fed. (2d) 408, by the Circuit Court of Appeals for the first circuit that premiums realized on a bond issue prior to 1913 are not taxable as income in the form of current amortization. This decision in the first circuit was afterward confirmed by this Court in a later litigation by the *Old Colony R. R. Co.*, 284 U. S. 552, to which we shall refer further under another point. The reasoning of the Circuit Court of Appeals for the first circuit, which was adopted by the Board and the Circuit Court of Appeals for the seventh circuit in denying amortization of prior-to-1913 incidental expenses, was that the premium realized on the sale of bonds was received by the corporation prior to the adoption of the Sixteenth Amendment and so had become capital prior to the adoption of that amendment and could not be reached by the subsequent income tax laws through the device of amortization. There is, however, no constitutional problem concerning the allowance of deductions from income. Deductions are wholly a matter of statute and as to them Congress is not controlled by any constitutional restriction. On the prior-to-1913 discount question involved in the same *Rock Island* case the analogy of the principle of the decision in the *Old Colony* case was urged but was rejected, the Board saying (13 B. T. A. at 1029):

> "What is income is controlled by the Constitution, "while deductions are a statutory concept. In the "years before us, the petitioner was on an accrual "basis for the reporting of income, not only because "that was the system necessary to reflect true in- "come, but because the Interstate Commerce Commis-

> "sion required such a basis. Income realized before "the adoption of the Sixteenth Amendment may not "thereafter be taxed, but as concerns deductions from "income, the same rule does not necessarily apply. "In the case of a continuing transaction, even though "it had its inception prior to February 25, 1913, there "may arise statutory deductions from income which "a taxpayer is not deprived of by reason of the "date of the enactment of the Sixteenth Amendment".

The above quoted language of the Board is as complete an answer in the case of commissions and expenses as in the case of discount to the claimed analogy of the principle of the *Old Colony* decision.

We do not accept as sound the decision of the Board or the decision of the Circuit Court of Appeals for the seventh circuit in the *Rock Island* case as to prior-to-1913 incidental expenses. It is not consistent to allow and require the amortization of such incidental expenses incurred after 1913 and at the same time to disallow the amortization of identical expenses incurred prior to 1913. But we do not wish to encumber this argument with a discussion of the proper status for tax purposes of incidental expenses. The question of the amortization of commissions can stand on its own feet. The question of what expenditures call for amortization necessarily involves some discretion and therefore requires that the line be drawn somewhere. It might well be sound to deny amortization to the incidental expenses of a bond issue because of their lesser importance in the exercise of discretion. This Court in denying certiorari on this question in the *Rock Island* case (284 U. S. 618) may have been influenced by this consideration.

POINT III.

Commissions, like discount, inherently represent allowances or payments as a part of the cost of conducting the corporate business in future years, and by reason of this inherent nature their amortization for tax purposes is required by the uniform practice.

Some confusion of thought is evidenced in the decisions, on the question of amortization of commissions and similar allowances or payments, which appears to be due to the separate treatment in the income tax laws of the various items making up the whole cost of doing business. Separate paragraphs authorize the deduction of ordinary and necessary expenses, of interest, of depreciation and exhaustion, of losses and of other items of cost not here material. The question is simplified if it is borne in mind that only that portion of any item of cost of doing business which is properly applicable to the tax year is chargeable against the income of that year, regardless of when it was paid and regardless of the classification of the item of cost among the various deduction paragraphs. If a payment is made in advance which is clearly applicable to future years, or if a liability is incurred which is clearly applicable to years prior to its maturity, amortization is essential in order to reflect correctly the income of the several tax years. This is the underlying principle of amortization. A taxpayer using the "cash" basis of accounting will probably not actually keep an amortiza-

tion account as to any item of cost. A taxpayer using the "accrual" basis may charge off a payment or a liability once for all in the year in which it is made or incurred. But, subject to some latitude in the case of items of minor importance where the taxpayer is on the "cash" basis, it is the practice of the Bureau, with the acquiescence of the taxpayers generally, to insist upon the observance of the amortization principle regardless of the taxpayer's accounting basis and regardless of the bookkeeping adopted by the taxpayer in the particular instance.

Both the Revenue Act of 1918 and the Revenue Act of 1921, which govern the present cases, include in the definitions under Section 200 the following: "The term "'paid' for the purposes of the deductions and credits "under this title, means 'paid or accrued' or 'paid or "incurred'," etc. All the other income tax laws, beginning with that of 1916, have contained the same provision in substance. Such provisions have constituted the authority under which the Bureau has applied the amortization principle.

The amortization principle as we have shown in the narrative of the development of the controversy has been applied uniformly to discount, commissions and incidental expenses of bond issues made after March 1, 1913.

Again, in the case not only of commissions for securing loans or selling bonds but also of commissions or bonuses for securing leases or other long term contracts, the deduction of the whole payment in one year is denied on the

ground that it is a part of the cost of the loan or lease or other contract which should be spread over the life of the loan or lease or contract and the proper amortization taken as an annual deduction. In *Emerson Electric Manufacturing Co.,* 3 B. T. A. 932, the Board referred to the principle governing commissions on bond issues as follows:

> "Further, it is clear to us that the revenue of a "day or a year should not be burdened with the cost of "acquiring additional capital, the benefits from which "will inure to the corporation over a long period of "years. This is the doctrine generally recognized and "adopted in the treatment of expenses incident to the "procuring of temporary capital through the flotation "of bonds and other term securities, and in such "cases the expenses are written off over the life of the "indebtedness".

In the *Rock Island* case, *supra,* in considering the question of incidental expenses incurred *after* March 1, 1913, the Board said (13 B. T. A., at p. 1035) that it was not impressed by the contention of the Commissioner that there was a distinction between discount and incidental expenses of issuing bonds, and further:

> "While such expenses do not so nearly coincide with "the concept of interest, they are, nevertheless, in- "timately connected with the loan and in fact con- "stitute a part of the cost of the money borrowed. "We see no reason for divorcing them from the loan "and holding them annual expenses".

See *S. & L. Building Corporation* case, 19 B. T. A. 788, 795, concerning commissions for securing a mortgage

loan on real estate, and *Bonwit, Teller & Co.* case, 17 B. T. A. 1019, 1024, concerning brokerage fees paid for securing a lease.

The same principle has been applied to require the amortization of cost of patents, copyrights, licenses or franchises (Art. 163 of Regulations 62, and *Hershey Manufacturing Co.* v. *Commissioner,* 43 Fed. (2d) 298), and the cost of baseball players' contracts (*Houston Baseball Assn.* v. *Commissioner,* 24 B. T. A. 69) and the purchase of an insurance agency contract (*Flynn, Harrison & Conroy,* 21 B. T. A. 285).

The cost of improvements on leased property which improvements will revert to the lessor at the end of the term constitute another class of expenditures the amortization of which is allowed. See *Kunkel & Co.,* 3 B. T. A. 133, 138-9. *Strand Amusement Co.,* 3 B. T. A. 770, 776. *Solicitors Recommendation* 2499 (IV-1 Cumulative Bulletin, p. 142).

The Commissioner and the Board have consistently applied the theory that such payments or allowances as the foregoing, concerning as they do the acquisition of something which benefits the taxpayer over a defined period, as distinguished from payments and allowances which exhaust their usefulness in the year when made, represent cost of the benefit for the full period of its life which can be taken as a tax deduction only in the form of amortization.

There is therefore no question in this case that the commissions involved are of such an inherent character as to be subject to the principle requiring amortization.

POINT IV.

Since both discount and commissions are subject to amortization, the annual amortization thereof applicable to the tax years under review must be allowed deduction under some name as constituting an item of cost of the business for those years, and the fact that they were incurred prior to 1913 is immaterial.

There are several classes of deductions authorized by the tax laws which may be considered applicable.

Deduction as Interest:

The allowance of amortization of bond discount has been rested on the reasoning that the discount constitutes deferred interest to be paid at maturity in addition to the nominal rate of interest currently paid during the life of the bonds. In the *Rock Island* case, the Board said (13 B. T. A. 1031):

> "It is significant that they (the official regulations) "are in harmony with general accounting practice, "which treats discount as deferred interest to be "spread over the life of the obligation."

and again at page 1033:

> "We are of opinion that in an economic and "accounting sense, the discounts, herein involved, "are in the nature of deferred interest, that they "may be accrued and that the proper proportionate "part applicable to each taxable year involved may "be taken as a deduction from gross income in such "year" etc.

By the same reasoning the commissions paid in connection with a bond issue constitute interest additional to the nominal rate carried by the bonds. This is so whether the commissions are to be considered fully equivalent to discount and therefore, like the discount, represented by a liability to be met at maturity, or be considered, unlike discount, as a payment made in advance as a part of the cost of obtaining the use of the new capital. In the one case the payment of the additional interest is deemed deferred to be paid at maturity; in the other case the additional interest is paid in advance. In either case amortization is necessary to reflect correctly over the life of the bonds the cost of the use of the borrowed money.

The Board has not, we believe, discussed in any discount question before it the question whether the deduction of the amortization is authorized specifically as an interest deduction or is to be recognized under some other classification of deductions. In both the Revenue Acts of 1918 and 1921 the allowable deductions for corporations were listed in Sec. 234(a) and paragraph (2) thereof specified:

> "(2) All interest paid or accrued within the taxable "year on its indebtedness",

there following an exception not here material. That specification may or may not be deemed entirely appropriate as express authority for the deduction of the additional interest represented by discount and commissions. It is unnecessary to discuss or determine that point, for there is no room for doubt that some one or more of the

specified classes of allowable deductions must cover such additional interest, so that, if the authority is not deemed to reside in the interest-deduction paragraph, it will certainly be found in some other deduction paragraph. The income tax laws have from the beginning embodied a very liberal policy as to the deductions allowed corporations. The policy has not been equally liberal in the case of individuals, who have not been allowed to deduct personal or living expenses or losses incurred in transactions not entered into for the purpose of profit. But the deductions allowed corporations, taken as a whole, evidence a broad intention and policy to allow the corporation to deduct under one name or another the entire cost of conducting its business.

The Commissioner does not refer, as we had supposed he would, to a second point decided by this Court in the *Old Colony* case, 284 U. S. 552. In that case the Commissioner, having been defeated in the earlier litigation [26 Fed. (2d) 408] on the question of his treatment of the amortized premium as income, urged that his result could be sustained by regarding his treatment of the amortized premiums as merely an offset against the nominal interest paid, for the purpose of determining the true net interest cost and limiting the taxpayer's deduction thereto. The Circuit Court of Appeals for the first circuit had in this later litigation adopted the new theory of the Commissioner [50 Fed. (2d) 896]. This Court, however, rejected the theory and held (p. 560) that Congress must be deemed to have used the word "interest" in the paragraph recognizing interest

as a deduction in the ordinary signification of the word. Accordingly it held that the taxpayer was entitled to the deduction of the full interest currently paid by it on its bonds, without the offsetting against such interest of the amortized premium. So we had supposed it would be urged here that on the same reasoning the interest deduction paragraph does not permit the deduction of something *in addition* to the nominal rate of interest paid on the bonds. It is, however, one thing to deny a taxpayer the deduction of the interest actually paid in the face of an express statutory authority for the deduction of the full interest payment, and it is quite another thing to hold that the statutory authority to deduct "all interest paid or accrued" is not elastic enough to embrace an additional cost of the taxpayer's borrowed money over and above the rate of interest nominally carried by the bonds. But again we say that it is not necessary to determine the question of the sufficiency of the interest-deduction paragraph to include the amortized discount and commissions, in view of other authorized classes of deductions which are readily applicable to such additional interest even if the specific interest-deduction paragraph is not considered applicable.

In conclusion under this heading we submit that it is not open to doubt that, if the amortized discount and commissions are entitled to deduction *as interest,* either deferred or paid in advance, they represent the part of the cost of the borrowed money applicable to the tax years in question, and that, even if this cost be considered as paid prior to 1913, it does not represent an *expense incurred for the period prior to 1913.*

Deduction as a loss:

In both the Revenue Acts of 1918 and 1921 the deduction of losses was authorized by paragraph (4) of Section 234(a) reading as follows:

> "(4) Losses sustained during the taxable year "and not compensated for by insurance or otherwise".

Regulations 33 (revised) adopted to govern the administration of the income tax law of 1916 provided in Article 150 as follows:

> "In cases wherein a corporation sells its bonds at "a discount plus a commission for selling, the amount "of such discount and commission, together with other "expenses incidental to issuing the bonds, constitutes "a loss, the aggregate amount of which loss will, for "the purpose of an income tax return, be prorated "over the life of the bonds sold, and the amount thus "apportioned to each year will be deductible from 'the gross income of each such year until the bonds "shall have been redeemed".

It will be noted that the above quoted article characterized the discount, commissions and expenses of a bond issue all as a *loss*. The official regulations issued under the later revisions of the income tax law have all contained a corresponding article providing for the amortization of discount, but without characterizing it in any way. We know of nothing, however, which indicates any change in the Bureau's view that discount, commissions and expenses constitute a loss to be amortized and deducted under the authority of paragraph (4) above cited. The

propriety of allowing the deduction of amortized discount, commissions and expenses under one or another of the paragraphs of the deduction section has simply been so universally accepted that it has not been necessary for either the Board or the Bureau to determine specifically which paragraph should be invoked.

Presumably the view that discount and commissions constitute a loss incurred on a bond issue rests upon the theory that the new capital obtained on the bond issue is the net amount of the proceeds realized, and that therefore the commissions equally with the discount are represented by a liability to be met at the maturity of the bonds. Under this view the amortization during the life of the bonds is in anticipation of the payment of the liability. Obviously under this view the annual amortization of the discount and commissions applicable to any tax years after 1913 represents an item of the cost of doing business in those years, although the loss will not become a completed transaction until the liability is met at maturity. *On this theory there is involved no expense incurred for any period prior to 1913.*

Deduction as exhaustion:

The case of *Julia Stow Lovejoy*, 18 B. T. A. 1179, involved the deduction of a commission paid to bankers for securing a loan which invokes the paragraph authorizing deduction for depreciation, exhaustion and obsolescence as the authority for the deduction of the amortized commission. The taxpayer was an individual and the loan was obtained for her business

purposes upon her mortgage notes. The Board sustained the Bureau's refusal to allow the deduction of the entire commission in the year in which it was incurred and held that it was an inherent cost of financing. The Board said at page 1182:

> "The result of this disbursement was that peti-
> "tioner had for ten or fifteen years the use of
> "another's money as the basis of deriving income.
> "Presumably, she believed, when she incurred these
> "items of cost and paid them, that she would secure
> "income enough to enable her to pay interest on the
> "loan and recoup these initial payments either out
> "of income or ultimate sale. The reasonableness of
> "such a supposition persists even if in the science
> "of accounting there were no device for recording the
> "continuing effect of the payment. That ordinarily
> "such a payment is not reflected among the assets of
> "a balance sheet is not controlling. If, notwithstand-
> "ing petitioner's so-called cash basis, she had pre-
> "pared a balance sheet and had included in her assets
> "this item by whatsoever designation so long as it
> "disclosed the facts, such a schedule would have been
> "beyond reproach.
>
> "In its essence such a disbursement is not unlike
> "bond discount, prepaid rent, cost of acquiring or
> "disposing of a leasehold or term contract and many
> "other transactions. They should be spread over the
> definite period of the loan, lease, or contract. * * *
> "This is on the theory that they result in property
> "of a sort and its cost is being exhausted propor-
> "tionately over a period of years and should be pro-
> "vided for on the basis of time, production, or other-
> "wise. Sec. 214 (a)(8)."

In the *Lovejoy* case above quoted the Board encountered some difficulty because of the fact that the taxpayer kept her accounts on a cash receipts and disbursements basis which would not have been present in the case of a taxpayer on the "accrual" basis of accounting. But the principle applies under either method of accounting. The principle is that the payment of commissions to bankers or underwriters for disposing of a new bond issue, or any comparable payment, in effect creates an intangible asset which may legitimately be set up on the asset side of the balance sheet as a payment made for the account of future years and which is subject to exhaustion charges in each subsequent year, such exhaustion charges being legitimate annual deductions for income tax purposes.

The reference at the end of the above quotation from the *Lovejoy* case to Section 214 (a)(8) as the paragraph of the law under which the deduction is authorized is a reference to the Revenue Act of 1924 which was applicable to that case. The paragraph cited concerned the deductions to which individual taxpayers are entitled. It read as follows:

> "(8) A reasonable allowance for the exhaus-
> "tion, wear and tear of property used in the trade
> "or business, including a reasonable allowance for
> "obsolescence."

In the 1924 Act Section 234 covered the deductions allowed to corporations which contained as paragraph (7) the identical language above quoted. The Revenue Acts of 1918 and 1921 which govern the present case contained

the deductions allowed to corporation taxpayers in Section 234 and in each act paragraph (a)(7) of that section authorized deductions for exhaustion, wear, tear and obsolescence in the same language as that above quoted from the 1924 Act.

Considering a commission payment as creating an intangible asset subject to exhaustion, no difficulty arises because of the fact that the commission was paid prior to the incidence of the income tax laws. Upon the incidence of the income tax laws the asset account will have been reduced by the charges for exhaustion during the prior period, but the balance of cost remaining unexhausted will stand as an asset subject to further appropriate exhaustion charges in the future years. Such charges made for exhaustion in the subsequent years constitute a part of the cost of doing business in those years.

There would be no more justification for disallowing the deductions for such current exhaustion on the ground that the cost had been paid prior to the incidence of the income tax laws than there would be justification for denying the deduction of depreciation after 1913 of the cost of a factory because such cost had been paid and the investment made prior to 1913.

Deduction as an ordinary and necessary expense:

Generally the cases involving commissions for securing loans and commissions and bonuses for securing leases, etc. arise because of the taxpayer's claim to deduct the entire amount of the commission or bonus in the year in which it was paid. The Board in rejecting such claims

and requiring amortization of the amount has frequently expressed the ground of its decision as being that the payments are not "ordinary and necessary expenses" in carrying on a trade or business but are a "cost" of the loan or lease which should be spread over the period during which the taxpayer enjoys the benefit of the transaction. We think the Board has unnecessarily denied to such commissions the character of ordinary and necessary expenses and has sought a different label because of an imaginary difficulty about otherwise denying the right to deduct the entire commission in the year in which it was actually paid. There is no apparent reason why either discount or commissions amortized over the years to which they apply may not be justified as ordinary and necessary expenses of those years. The Board is clearly in error if it thinks that the question whether an expenditure is deductible in one year or should be amortized can be determined by the particular name or classification which it assigns to the item.

It is bookkeeping of the most common occurrence to amortize ordinary and necessary expenses, although usually only over a short period. A very familiar and everyday example of this practice is involved in the payment of fire insurance premiums for several years in advance. Such proportion of the payment as is applicable to the years subsequent to the year of payment should be charged to the proper expense account of the subsequent years as those years are reached, and in the meantime should appear as a "suspense" item. In other words, an advance payment for something belonging to future years should not be charged as an expense of the year

in which the payment is made and, until it can properly be finally charged out, it may be booked as a suspense item on the asset side of the accounts. Whatever the actual bookkeeping, it is in effect an asset, since it takes the place of the cash expended and is as good as cash in that it has reduced the actual disbursements necessary to be made for the cost of doing business in the subsequent years.

Again it is not uncommon for rent to be paid for one year or more in advance. The treatment of such advance payments for tax purposes would be identical with that of the payment of insurance in advance above discussed. The advance payment of rent bears a very close analogy to commissions in connection with a bond issue. The commission, as has been stated, represents a part of the cost of the use of the borrowed money. As such it could appropriately be denominated "rent" paid for the use of the money.

In both the Revenue Acts of 1918 and 1921 the deduction by corporations of ordinary and necessary expenses of the business are authorized under Sec. 234(a) by paragraph (1) thereof as follows:

> "(1) All the ordinary and necessary expenses paid "or incurred during the taxable year in carrying on "any trade or business, including a reasonable allow- "ance for salaries or other compensation for personal "services actually rendered, and including rentals or "other payments required to be made as a condition "to the continued use or possession of property to "which the corporation has not taken or is not taking "title, or in which it has no equity."

Throughout the administration of the income tax laws the paragraph authorizing the deduction of ordinary and necessary expenses has been administered in a very liberal way. No narrow interpretation of the words "ordinary" or "necessary" has been adopted. As a few examples of payments which under an interpretation having any narrow tendency might have been considered "extraordinary" rather than "ordinary": A lessee executing a lease, to become effective two years later, paid $200,000 to cover losses which the lessor feared might be suffered during the intervening two years through removals of existing tenants or reduction of existing rentals, and this payment was allowed as an ordinary and necessary expense of the lessee, although required to be amortized over the life of the lease (*Saks & Co.,* 20 B. T. A. 1151). A heavy expense of defending a patent litigation was allowed (*F. Meyer & Bro. Co.,* 4 B. T. A. 481). Attorneys fees and expenses of some $162,000 incurred by an individual in the successful defense of his prosecution for conspiracy to defraud the United States in the matter of taxes of the corporation of which he was chief executive were allowed as his ordinary and necessary expenses (*Peoples-Pittsburgh Trust Co., et al. Executors,* 21 B. T. A. 588). The cost of an automobile given every six months by a corporation operating restaurants as a prize to be drawn by lot by its customers was allowed as a business expense (I. T. 1667; II-1 Cumulative Bulletin 83). A cost of $1,000,000 incurred by the Association of Railway Executives in an advertising campaign at the end of Federal control of the

railroads for the improvement of the attitude of the public toward the railroads, shared proportionately by the railroad corporations members of the association, was allowed deduction by them respectively as a business expense (*Los Angeles & Salt Lake R. R. Co.,* 18 B. T. A. 168).

A recent opinion of the general counsel of the Bureau of Internal Revenue (General Counsel's Memorandum 13148 dated June 18, 1934) upholding the amortization under all income tax laws beginning with that of 1918 of insurance premiums paid in advance for a period of more than one year is very pertinent to this discussion and it is printed in full as an appendix to our answer to the petition for certiorari herein.

The foregoing miscellaneous examples show that such amortized discount and commissions could readily be justified as a deduction as an "ordinary and necessary expense" of the corporate business. It would seem quite unnecessary to go further afield and invoke the authority for deduction of interest, or of losses, or of exhaustion of cost of property.

Considering bond discount and commissions as an ordinary and necessary expense, no difficulty arises as to the allowance of their amortization in the current tax years because of the fact that they were incurred prior to the incidence of the tax laws. The unamortized portion of the discount and commissions remaining upon the incidence of the income tax laws represents expenses incurred as a part of the cost of the business for the future tax years,

to be charged as expenses of those years as they arrive, and cannot be disallowed as expenses incurred for the period prior to the incidence of the income tax laws.

CONCLUSION.

The decision below should be affirmed.

Respectfully submitted,

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